

Does Corruption Affect Foreign Direct Investment Inflows in SADC Countries?

Moses Garai Chamisa ^{a,*}

^a*Midlands State University, chamisamg@gmail.com, Zimbabwe*

Abstract. Foreign direct investment (FDI) is a critical factor in development of SADC. However, corruption remains to be an obstacle to economic transformation in these countries. Empirically, studies provide controversial results on the impact of corruption on FDI. Some studies conclude that corruption negatively impacts FDI inflows in a country, while others provide evidence that corruption can act as a 'helping hand' to FDI inflows in a country. Given this ambiguity in the results of previous studies, utilizing a panel data set for the period 2000-2016 for 15 SADC countries, the study examines the impact of corruption on FDI inflows in these countries. Lack of attention in previous studies on the effect of corruption on FDI inflows in SADC motivated this research. Estimation results using a robust random effects model show that when corruption is widespread in a country, foreign investors are reluctant to invest. Thus, corruption negatively affects FDI inflows in SADC countries. The study recommends that SADC countries should develop and implement efficient, effective, and strong anti-corruption measures to reduce corruption and hence increase FDI inflows.

Keywords: Corruption, Foreign Direct Investment, SADC Countries

* Corresponding author: chamisamg@gmail.com

Introduction

This study is an econometric analysis of the influence of corruption on foreign direct investment (FDI) inflows in Southern African Development Community (SADC) countries. FDI inflows are key in creating employment opportunities, providing capital, and improving productivity. UNCTAD (2014) defines FDI as the amount of equity capital that a country receives, as shown in the balance of payment. Competition for FDI has increasingly intensified, and host nations strive to attract FDI by providing fiscal incentives and the necessary infrastructure to post themselves as attractive investment destinations.

Despite the progressive and well-intended overtures, most SADC countries face some negative governance issues that militate against their efforts to land lucrative investors. Chief among these is corruption, a scourge that permeates governance structure in both public and private offices. Corruption is the exploitation of the public office for personal gain. Corruption is an additional cost to businesses and a tax on profits and dampens FDI inflows, thereby hindering economic growth in developing countries (Ali-Sadig, 2009). While investors consider tax and non-tax factors in choosing an investment destination, corruption attracts more attention. Consequently, most investors will consider, foremost, the host country's corruption levels in making foreign investment decisions. On the other hand, governance structures that have deliberate measures in place to curb corruption are more likely to attract foreign investment than loose national governance structures.

Unfortunately, existing literature shows that less consideration is given to a very important issue that is, solving the problem of corruption, particularly in developing countries. Practical proof of the effect of corruption on FDI inflows is relatively inadequate despite the huge literature on the causes of FDI. A worrying phenomenon is that there is a likelihood of investors to willingly or unwillingly participate in corrupt processes as part of their strategies against competing fellow investors. Most previous studies on the effects of corruption on FDI included very few African countries, yet African countries are ranked very low on the global corruption perception index. The irony is that most African economies are endowed with abundant natural resources and therefore attract investors, yet their weak governance structures expose them to local or inbound corruption involving investment contracts and deals.

According to the researchers' information, there are very few empirical studies on the impact of corruption on FDI inflows in SADC countries. Furthermore, most previous studies used a cross-sectional data approach to investigate the impact of corruption on FDI inflows in a host country. This method or approach fails to govern for the unnoticed country-specific effects that vary across nations interrelated with corruption. It should be noted that Africa and SADC in particular, despite its rich natural resource base, especially minerals, has received the lowest proportion of FDI inflows to developing countries. In addition, it suffers from a proverbial resource curse. Some reasons have been put forward, including high levels of corruption, political instability, and small market size, among others.

Both empirical and theoretical evidence suggests that grant corruption is deleterious to FDI inflows. However, statistics on FDI inflows and corruption levels for SADC member states show a distorted picture of the association between corruption and FDI inflows in these countries. For example, DR Congo and Mozambique ranked as the most corrupt receive more FDI inflows than those ranked least corrupt such as Botswana and Seychelles. Hence, it is imperative to investigate the impact of corruption on FDI inflows in the region. In that investigation, it could also be worthwhile to explore the hypotheses that despite the corruption involved in landing investment deals in corrupt countries, the cost of doing business pales in the face of the gains after that, especially where both the investor and the country's office holders sleep between the same pair of sheets. The contra factual is that corruption may not necessarily negatively affect FDI, but rather, increase the competition among potential investors, making a high corruption economy an attractive investment destination for two reasons. First, high stakes usually point to high gains, and second proceeds of the investment can be externalized through corruption because the same system that facilitates investment through corruption is also responsible for the policies governing accountability, taxation, and exchange control.

The study's principal objective is to investigate the effect of corruption on FDI inflows in SADC countries and to generate a set of assertions that can be used to draw conclusions and recommendations. In this vein, the study will attempt to provide answers to the following questions: What are the effects of corruption on FDI inflows in SADC? Is there a statistically significant relationship between corruption and FDI inflows? What are the key causes of FDI inflows in SADC? The study attempts to address the null

hypothesis that the association between corruption and FDI inflows is statistically insignificant against the alternative hypothesis that the association is statistically significant.

Literature Review

Overview of Corruption

The abuse of public office for personal gain is not a new problem, and it is a consistent, repetitive, and essential part of the set-up of most political systems (Iyanda, 2012). Goulb and Kolb (1964) pointed out that corruption is prevalent in both dictatorial and party systems of the government.

Akinyemi (2004) described corruption as the gaining of that which one, as a public official, is not eligible to. On the other hand, Doig (ibid) described it to be any use of the authorized position, means, or amenities for personal benefit. This definition tallies with Transparency International (2009), which defined corruption as “the abuse of public office for private gain”. According to Al-Sadiq (2009), corruption has an impact on the distribution of resources and involves the abuse of public or collective duty for personal ends. It should be noted that corruption also occurs from the giver and recipient as if this were a contract. Not all cases of corruption emanate from demand, but some also emanate from inducements offered to office bearers who may not necessarily have set off to abuse their office for gain but are inducted into corruption because of a weakness in their integrity disposition.

Three wide categorizations of corruption are not mutually exclusive. These are grand corruption, petty corruption, and business corruption. Moody-Stuart (1997) referred to grand corruption as the abuse of public power by heads of state, relevant ministers, and top civil servants for private pecuniary profit. Petty corruption is the abuse of public office for private gain in the course of delivering a public service. It occurs at the operation end of politics, where public officials interact with the public. Unlike grand corruption, which involves large sums of money, petty corruption typically comprises trivial amounts of money in the form of bribes (grease money or speed money) to public officials. Business corruption is not often viewed as a crime, but as a means to fast-track business processes. Supporters claim that through business corruption, red-tape is bypassed and time is utilised. Business corruption takes the form of bribes,

insider trading, money laundering, tax evasion, and embezzlement.

Overview of FDI

FDI is defined as long-term investment by a resident entity in one economy in an enterprise resident in another economy (UNCTAD 2007). There are two main classes of FDI, namely macroeconomic and microeconomic theories (Makoni, 2015). Macroeconomic theories view FDI as a form of the movement of capital across national boundaries reflected in the balance of payment statistics. According to these theories, FDI is determined by market size, economic growth rate, GDP, infrastructure, natural resources, and institutional and non-institutional factors. Microeconomic theories examine FDI incentives from the investors’ viewpoint, which is similar to taking a company level or industry-level standpoint in making a decision.

FDI has its advantages and disadvantages to a host country. First, it boosts a country’s economy by introducing new goods, foreign technology, and creating a stock of knowledge in a receiving nation through the transmission of skills (Mahembe and Odhiambo, 2013). Second, FDI plays a vital role in filling the funding gap between local savings and investment requirements and can reduce the need for debt capital in a country. However, Sen (1998), is of the opinion that MNCs only transfer inappropriate or non-strategic technologies, and Moura and Forte (2009) argue that host countries can become dependent on technologies introduced by MNCs. Finally, FDI exerts a far more significant impact on imports than exports, which negatively influences the balance of payments.

Theoretical Link between Corruption and FDI

The link between corruption and FDI is a well-researched topic, yet there is no conclusive study on the effects of corruption on FDI. For this reason, one must distinguish between corruption with a negative social benefit (corruption as ‘grabbing hand’) and corruption with the positive social benefit (corruption as ‘helping hand’).

“The Grabbing hand” theory of corruption claims that vice is an enemy of economic activities in that it increases the costs of doing business (Alemu, 2012). According to this theory, corruption reduces FDI inflows and attracts lower-quality investments. A survey by TI in 2008 found out that corruption rose the

cost of investing by more than ten percent (Transparency International, 2009). Government incomes become low due to high corruption, which may lead to pitiable infrastructure, an element that is unattractive for foreign investors (Egger and Winner, 2005). This form of corruption may attract the kind of investor who may not necessarily honor their obligations. Even when the host economy does not agree with the eventual undesirable economic conduct of the investor, their lips are sealed, and their actions are incapacitated as they are held at ransom because of bribes accepted at the onset of the investment.

China is placed top of corrupt countries in the world, whereas at the same time, it has experienced an increase in FDI inflows and is projected by UNCTAD to be the most favored destination for FDI. Consequently, the 'helping hand' theory of corruption can be used to explain this phenomenon. Some authors argue that corruption can act as a "helping hand" by lubricating the rolls of business in the absence of strong legal and regulatory frameworks resulting in Pareto efficiency (Bardhan, 1997). Tullock (1996) is of the opinion that corruption can raise economic growth in emerging economies because bribes complement low wages, allowing administrations to keep the tax burden low. According to economists such as Lui (1985) and Saha (2001), corruption can be competent 'lubrication' for inflexible economic regulation and red tape. By corrupting the host government, MNCs could sneak regulations and red-tape and possibly obtain a large amount of benefit from the host government regarding lucrative contracts, advantaged access to markets that cannot be obtained by exporting, which could act as an extra motivation for the MNCs to engage in FDI. In this regard, it is acknowledged that regardless of corruption that facilitates investment, the eventual investment may very well proceed to benefit the economy.

Empirical Link between Corruption and FDI

1. Negative Relationship

Mauro (1995) concluded that high levels of corruption result in low foreign investment. Castro and Nunes (2013) suggested that lower corruption levels result in greater FDI inflows, thereby suggesting that managing corruption may be a vital plan for increasing FDI inflows. A study by Quanzi (2014) found out that the effect of corruption on FDI is considerably negative and strong, which confirms the

"grabbing hand" proposition. Ogunmuyiwa (2012), using the case of Nigeria argued that in the long run corruption has adverse influence on FDI in line with arguments of the "grabbing hand" theory. A study by Azam and Ahmad (2013), on the effects of corruption on FDI, concluded that (MNCs) tend to shun nations with high corruption rates. A study by Al-Sadiq (2009) confirmed other previous studies noting an adverse association between the corruption level and foreign investment inflows. Freckleton, Wright, and Craigwell (2011) suggested that corruption is now recognised as a policy variable that influences aspects of both social and economic life. Habib and Zurawicki (2002) found out that foreign companies shun corruption because it causes inefficiency. A study by Wright and Craigwell (2011) found out that sufficient institutional facilities must be in place in emerging economies to fight corruption and increase foreign investment. Alemu (2012) concluded that countries with high levels of corruption but with remarkable FDI inflows can double their foreign investment inflows by managing corruption. On the other hand, some studies argue that the type of FDI is a vital denominator to the input of corruption. For instance, Brouthers, Gao, and MacNicol (2008) separated market-seeking FDI and resource-seeking FDI. The study revealed that the market-seeking FDI was less sensitive towards corruption, while resource-seeking FDI was more sensitive to the level of corruption. The study concluded that despite having attractive resources, high levels of corruption reduce FDI inflows.

2. Positive and Neutral Relationship

There is ancillary proof that corruption lubricates the wheels of business rather than sanding them. Egger and Winner (2005) found a clear and affirmative relationship between corruption and FDI. Similarly, using fixed effects estimation, Hines (1995) also found a positive relationship between FDI inflows and corruption levels. A study by Mi (2013) found out that corruption has no tangible or major influence on FDI. In his study, Kim (2010) found out that countries with high levels of government corruption and low democracy receive high FDI inflows. Gutierrez (2015) provided evidence that a high level of corruption does not effect FDI inflows in Argentina

because foreign companies concentrate on the exploitation of natural resources. Ackay (2001) failed to recognize any significant impact of corruption on FDI.

Other Factors that Influence FDI

Literature on the factors that influence FDI has revealed that corruption is not the only variable that affects FDI inflows. In the current study, other factors that affect FDI are used as control variables. First, market size implies that the bigger the market, the more the chances it offers in terms of sales and revenues to MNCs (Bissoon, 2011). The market size hypothesis points out that FDI is presumed to be a function of the size of the target market. Second, the infrastructure variable includes roads, ports, railways and telecommunications, and energy to institutional development (Demirham and Masca, 2008). Jordan (2004) claimed that quality infrastructure increases the productivity of investments, and therefore encourages FDI inflows. Third, openness to trade measures the degree to which a country is open to the rest of the world. When investment is market seeking, trade restraints can have a positive impact on FDI because MNCs will set up branches in a host country. In contrast, export-oriented FDI favors more open economies since increased inadequacies that go together with trade protection imply higher transaction costs associated with exporting. Fourth, a stable social and political environment strongly affects FDI. Political instability in a country will reduce the profitability of operating in the host country because production is disturbed. It also affects the value of the host country’s currency, thus decreasing the value of the assets capitalized in the host country. Finally, a low inflation rate stimulates more investment. Contrary, a high inflation rate signals economic instability (Ardiyanto, 2012).

Research Methodology

Choice of Methodology

The study utilizes a panel data research methodology. The panel data approach combines two dimensions: cross-sectional and time series dimensions. This gives the researcher many observations, thereby increasing the degrees of freedom and decreasing collinearity among explanatory variables. This improves the effectiveness of econometric estimates (Kadenge and

Madzivanyika, 2015). Panel data helps to account for individual heterogeneity across countries, which is not possible with time-series and cross-sectional studies.

Data and Data Sources

Table 1
Data and Data Sources

Description	Data Source	Anticipated Sign
FDI	UNCTAD	
GDP per Capita	UNCTAD	Positive
Inflation	World Development Indicators	Negative
Openness to Trade	UNCTAD	Positive
Corruption	Transparency International	Negative
Political Risk	World Governance Indicators	Negative
Infrastructure	Africa Development Bank	Positive

Specification of the model

The Empirical analysis adopts the following model:

$$\begin{aligned}
 \text{LnFDI}_{it} &= \beta_0 + \beta_1 \text{LnCorruption}_{it} \\
 &+ \beta_2 \text{LnGDP per Capita}_{it} \\
 &+ \beta_3 \text{LnInflation}_{it} \\
 &+ \beta_4 \text{LnInfrastructure}_{it} \\
 &+ \beta_5 \text{LnRISK}_{it} \\
 &+ \beta_6 \text{LnOpenness to Trade}_{it} \\
 &+ e_{it}
 \end{aligned}
 \tag{1}$$

Where:

- FDI = Foreign Direct Investment inflows as a % of GDP
- Corruption = Corruption Perception Index
- GDP/Capita = GDP per Capita (proxy for market share)
- Inflation = Inflation Rate (proxy for economic stability)
- Infrastructure = Infrastructure
- Risk = Political risk
- Openness to Trade = Degree of Openness
- e_t = error term
- β_0 = Constant
- $\beta_1 \dots \beta_6$ = Coefficients of the independent variables
- i = cross-sectional variations
- t = time variations

All the variables are transformed to natural logarithms to reduce the risk of heteroskedasticity. The study recognizes that FDI decisions may be made based on past data.

Data Presentation and Analysis

Variable inflation factors (VIF) test results are presented in Table 2.

Table 2
VIF Test Results; Source: Own Calculations

Explanatory Variable	VIF	1/VIF
Corruption	4.63	0.216
GDP per Capita	3.24	0.309
Inflation	2.26	0.442
Infrastructure	1.82	0.549
Political Risk	1.48	0.676
Openness to Trade	1.28	0.783
Mean VIF	2.45	

The following are the diagnostic tests that were carried out to prove the vigor of the results obtained. First, multicollinearity test results show VIFs (Variance inflation factors), which are lower than 10 and 1/VIFs greater than 0.1. This means that VIF quantifies the extent of multicollinearity in a regression analysis. They provide an index that calculates the variance of a regression coefficient that is amplified because of collinearity. There was no multicollinearity among the explanatory variables.

Second, heteroscedasticity was tested using Breusch-Pagan and Cameron and Trivedi's decomposition of the IM-test. The Breusch-Pagan test has a chi-square of 6.41, and a probability of 0.0113. In addition, Cameron and Trivedi's decomposition of the IM-test has a probability value of 0.0002. The fact that the results of these two tests have probabilities that are less than 5% implies that the variances of residuals are heteroscedastic, and to correct for heteroscedasticity, a robust random effects model was used.

Third, the Breusch-Pagan Lagrangian Multiplier Test was used to test for the existence of autocorrelation in the estimated model. The results show a chi-square of 163.20 and a probability of 0.2341. This result indicates no autocorrelation in the model.

Finally, to test whether we should use the fixed effects model or the random effects model in panel data, the study used the Hausman test. The chi-square for the Hausman test was found to be 10.13, and its

probability value was found to be 0.1192. Since the probability value of this test is greater than 0.05, this means that the research will be based on a random effect model.

Robust random effects model estimates results are summarized in Table 2. Wald chi-square is 32.61, which means that the coefficients of all independent variables are not equal to zero and the probability of 0.0000 indicates that the model significantly explains the relationship between the dependent variable and independent variables.

Corruption significantly influences FDI in SADC at the 5% level of significance in both models estimated. The negative influence of corruption on FDI inflows decreases when controls are introduced into the regression model (see the coefficients). The results are in line with many papers, Mauro (1995), Wedeman (1997), Teksoz (2004), Ali-Sadig (2009), Freckleton, Wright and Craigwell (2011), and Egger and Winner (2005) who accepted corruption as a barrier to FDI inflow. The coefficient of corruption in the model is adverse and confirms previous practical studies on the association between corruption and FDI.

Table 3
Estimation results

Explanatory Variables	Coefficient Estimate	t-value	St. Errors
Corruption	-1.130	-2.25**	0.503
GDP per Capita	-0.049	-0.32	0.151
Inflation	-1.06	-1.23	0.858
Infrastructure	0.089	0.61	0.146
Political Risk	0.689	0.48	0.147
Openness to Trade	1.509	4.08***	0.369
Constant	-3.45	-2.45**	0.445

N = 236
Wald $\chi^2 = 32.61$
Prob > $\chi^2 = 0.0000$

***1% level of significance, and **5% level of significance

A negative association between FDI and market size exists, as indicated by the coefficient. Market size is insignificant in influencing FDI inflows in SADC. This contradicts many studies that found that market size influences FDI. For instance, Indopu (2010) and Al-Sadiq (2009) found a positive association between host country market size and FDI inflows. Such studies concluded that FDI is enticed to a country with bigger market size.

Inflation, a proxy of macroeconomic stability, has a negative relationship with FDI. However, its effect is statistically insignificant, implying that investors do not care much about the macroeconomic environment obtaining in a country. The coefficient of inflation is negative as expected. The results of this study are inconsistent with previous studies such as Indopu (2010), and Bissoon (2011) who concluded that macroeconomic uncertainty has a noteworthy negative impact on FDI.

Political risk is positively related to FDI inflows. This positive association indicates that the political environment in a host nation does not bother foreign investors or MNCs in SADC. Instead, the more politically unstable a host country is, the more FDI it receives. However, the association between political risk and FDI is insignificant. The result is contrary to the expected negative association between political risk and FDI. The result also contradicts findings of previous researchers.

Openness to trade is significant in determining or influencing FDI inflows in SADC, and its coefficient is positive, as expected at the 1% level of significance. This implies that good trade policies attract foreign direct investment. This result is in line with the outcomes of Asiedu (2002), who studied the causes of FDI in Africa. Good infrastructure attracts FDI, and this is evidenced by the results that show a positive relationship between FDI and infrastructure as expected. The latter result supports the findings of Rahman, Kisunko and Kapoor (2000). However, from the estimated regression results, infrastructure is statistically insignificant in influencing FDI. In addition, Mahembe and Odhiambo (2013) found that poor infrastructure negatively affects FDI inflows.

In summary, the outcomes of the model reveal that corruption and openness to trade have a significant impact on FDI inflows in SADC. However, empirical results show that macroeconomic instability, market size, infrastructure, and political risk do have an insignificant impact on FDI in SADC.

Discussion and Conclusion

There are a few types of research carried out on the influence of corruption on FDI inflows in SADC. Most research on this topic covers SADC countries under umbrella terms such as developing countries and Africa. Furthermore, most previous studies used cross-sectional and pure time-series analysis to investigate the impact of corruption on FDI inflows. This research aims at closing this gap by investigating

the effects of corruption on FDI inflows using the robust random effects model on a panel data set of 15 SADC countries for the period 2000-2016. The research objective was to analyze the effect of corruption and its statistical significance on FDI inflows in SADC. The study concluded that corruption has a significant and negative effect on FDI flows to SADC countries. This confirms other previous studies, Mauro (1995), Wedeman (1997), Teksoz (2004), Al-Sadiq (2009), Freckleton, Wright and Craigwell (2011), and Egger and Winner (2005), who provide some evidence of a negative relationship between corruption and FDI.

The research needed to answer the question "What are the key causes of FDI inflows in SADC?" First, on the empirical results on the relationship between the level of corruption and openness to trade, it can be concluded that the lower a country's score on a scale of 0 (highly corrupt) to 10 (least corrupt) the less FDI it receives. Second, from the positive association between openness to trade and FDI inflows, we can conclude that the more a country is open to international trade the more foreign investment it receives. Third, we conclude that macroeconomic instability negatively affects the flow of FDI to SADC countries though insignificantly. Fourth, we conclude that even though infrastructure is positively related to FDI, it insignificantly influences the flow of foreign investment to SADC, which may imply that foreign investors in SADC are not much worried about the level of infrastructure development in a host country. Finally, we conclude that market size and political risk have no influence on FDI in SADC countries.

On the policy front, the study recommends that policymakers in SADC countries should put in place efficient, effective, and robust anti-corruption measures to reduce corruption and attract more FDI inflows. In addition, an improvement in a country's CPI ranking will significantly improve the country's attractiveness to foreign investors, and hence large inflows of FDI. As a result, policymakers should give corruption as a feature in their investment policies some great attention. This might mean even going a step further by incorporating anti-corruption measures in all policies, giving much attention to those policies directly or indirectly linked to investment. Lastly, SADC countries should strive to support international approaches to deal with corruption. This might mean incorporating international anti-corruption strategies into domestic laws. SADC countries should design sound macroeconomic policies that are consistent and predictable in promoting international trade.

The CPI used to measure corruption may not be ideal because it collects data on corruption perceptions based on surveys and questionnaires, which are subjective. As a result, it is difficult to collect information on every corrupt action. Hence, detailed research on more accurate corruption indices, particularly for SADC, would help in future research. Furthermore, the CPI used in this research is an aggregate measure of corruption, and using it in analyzing the impact of corruption on FDI may give biased results. It is suggested that further research on this critical topic can be conducted using the diverse types or forms of corruption so that those types that negatively affect FDI can be disclosed. This will help in developing effective targeted anti-corruption strategies that will improve the appeal of a country to foreign investment. Further research could be conducted on the impact of corruption on FDI that flows to each sector of the economy.

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Appendix: Country Sample

Angola	Malawi	South Africa
Botswana	Mauritius	Swaziland
DRC	Mozambique	Tanzania
Lesotho	Namibia	Zambia
Madagascar	Seychelles	Zimbabwe